ANALYSIS OF ORIGINAL BILL

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Bill Number: AB 1854

Related Bills: See Legislative History
Telephone: 845-4786
Introduced Date: 02/07/2000

Attorney: Patrick Kusiak
Sponsor:

SUBJECT: Earned Income Credit

SUMMARY

This bill would provide a nonrefundable Earned Income Credit (EIC) in an amount equal to an unspecified percentage of the earned income credit allowed by federal law. This bill also would provide that the Franchise Tax Board (FTB) shall train and inform employers regarding employees being allowed to make withholding adjustments to reflect the credit.

EFFECTIVE DATE

This bill would be effective immediately upon enactment and would apply to taxable years beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

SB 1421 (2000) proposes a refundable EIC, AB 2466 (2000) proposes a nonrefundable EIC, and AB 2490 (2000) would require employers to notify their employees of the availability of the federal EIC. AB 1370 (1999), which would have required employers to notify their employees of each employee’s possible eligibility for the federal earned income credit, was vetoed. SB 43 (1997), AB 83 (1997) and AB 470 (1997) each proposed an EIC. SB 43 and AB 470 failed to pass out of the first house by January 31 of the second year of the session; AB 83 failed passage in Senate Appropriations.

PROGRAM HISTORY/BACKGROUND

Prior to its sunset in 1992, California law provided a nonrefundable low-income tax credit of an amount ranging from 20% to 100% of the “computational tax,” as defined, based on the taxpayer’s adjusted gross income (AGI). The AGI amounts were indexed annually by the FTB. The “computational tax” was defined as the regular tax less all nonrefundable tax credits. This low-income tax credit could only be taken after all other allowable credits, except refundable credits.

SPECIFIC FINDINGS

Existing federal law allows eligible individuals a refundable EIC. A refundable credit allows for the excess of the credit over the taxpayer’s tax liability to be refunded to the taxpayer. The credit is a percentage of the taxpayer’s earned income and is phased out as income increases. The percentage varies, based on whether the taxpayer has qualifying children.

Board Position:			Department Director	Date
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The **federal** credit for the 1999 taxable year is determined as follows:

Eligible Individual with	Earned Income	Completely Phased-out @	Credit %	Maximum Credit
1 qualifying child	$6,800	$26,928	34	$2,312
2 or more qualifying children	$9,500	$30,580	40	$3,816
no qualifying children	$4,500	$10,200	7.65	$347

Workers cannot claim the federal EIC if their 1999 investment income (such as interest and dividends) is more than $2,350. The amount of the federal EIC is reduced by the alternative minimum tax (AMT), if any.

Existing federal law specifies that if the federal EIC was denied and it was determined that the error was due to reckless or intentional disregard of the federal EIC rules, the EIC will not be allowed for the next two years. If the error was due to fraud, then the EIC will not be allowed for the next ten years.

Existing federal law allows an eligible individual to receive advance payment of the EIC in his or her paycheck by adjusting the amount of tax withholding. This is accomplished by providing his or her employer with a Form W-5. Taxpayers who receive advance payments of the EIC must file an income tax return. Any advance payments that exceed the allowable EIC are recaptured. While EIC recipients may pay little or no income tax, allowing the EIC to be received through advance payments is intended to offset the burden of social security and other payroll taxes.

Existing state law provides various personal credits to taxpayers that may reduce (but not below zero) their state income tax. Existing state law does not provide an EIC. Existing state law provides general rules that apply to the division of credits among two or more taxpayers, a husband and wife, and partners.

State law provides a personal exemption credit of $72 for each taxpayer, plus an additional exemption credit for those individuals who are over 65 years of age or are blind, and an exemption credit of $227 for each dependent. These amounts are for 1999 and are increased annually for inflation.

Under **state law,** individuals who make less income than the filing thresholds are not required to file an income tax return since the standard deduction and personal exemption credit would eliminate any tax liability. For 1999, these filing thresholds are $10,899 in gross income or $8,719 in AGI for single taxpayers and $21,798 in gross income or $17,438 in AGI for married filing joint taxpayers. These thresholds are increased based on the number of dependents. These thresholds also are increased annually for inflation.

This bill would provide a nonrefundable EIC in an amount equal to an unspecified percentage of the earned income credit allowed by federal law.

This bill would provide that the FTB shall train and inform employers regarding employees being allowed to make withholding adjustments to reflect the credit.

This bill would allow a carryover of any portion of this credit that exceeds the taxpayer’s tax liability until the credit is exhausted.

Policy Considerations

Most taxpayers eligible for the federal EIC probably have little or no federal or state tax liability. If the author's intent is to provide assistance to low-income taxpayers, the bill may not accomplish that intent since a nonrefundable credit can only be taken as an offset against tax liability. Taxpayers with AGI below specified amounts, shown below, have no filing requirement.

Single (no dependents) $8,719

	1 Child	2 or more Children
Head of Household	$16,286	$21,961
Married Filing Joint	$25,005	$30,680

This bill does not specify a repeal date nor limit the number of years for the carryover. Credits typically are enacted with a repeal date to allow the Legislature to review their effectiveness. However, even if a repeal date were added, the department would be required to retain the carryover on the tax forms indefinitely because unlimited credit carryover is allowed. Recent credits have been enacted with a carryover limit since experience shows credits are typically used within eight years of being earned.

To avoid making low-income taxpayers contend with the complexities of computing AMT, the author may wish to amend the bill to allow this credit to reduce the regular tax below tentative minimum tax.

Implementation Considerations

The proposed credit under this bill would be claimed by low-income taxpayers. Low-income taxpayers generally file their tax returns on forms 540A, 540EZ or 540-2EZ. To minimize the complexity of these returns, credits that are allowed against net tax, other than the nonrefundable renters' credit, are not currently allowed on these forms. Adding lines to these forms would increase their complexity and could have a moderate to significant impact on the department's operations.

This bill would require the FTB to provide training and information directly to employers; however, the Employment Development Department (EDD) advises employers on matters relating to withholding. If such information could be provided indirectly through this department's normal methods for providing information to tax preparers and taxpayers (i.e., instructions with tax forms, the Tax News newsletter) or through EDD advisories, this provision would not cause significant problems. If this department were required to contact all employers in the state, significant resources would be required to implement this provision. Clarification is needed before the department could implement this portion of the bill.

It is unclear if taxpayers would be ineligible for the state credit because of reckless or intentional disregard of the rules or because of fraud in claiming the state credit as provided under federal law.

Many taxpayers who qualify for the EIC may not have a filing requirement. Therefore, procedures would need to be established to enable such taxpayers to document their California EIC for carryover purposes.

FISCAL IMPACT

Departmental Costs

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved.

Tax Revenue Estimate

For this analysis, it is assumed that the credit percentage would be 100% of the federal amount.

This bill is estimated to create revenue losses under the Personal Income Tax Law as shown in the following table.

Fiscal Year Cash Flow Taxable Years Beginning After December 31, 1999 Enactment Assumed After June 30, 2000 $ Millions		
2000-01	2001-02	2002-03
-$15	-$16	-$16

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The number of qualifying taxpayers will determine the revenue impact for this bill and the amount of earned income on which the credit is based.

These estimates were derived from the Department's Personal Income Tax Model and grown by the U.S. Treasury growth rates specifically for the federal earned income credit.

BOARD POSITION

Pending.